

# Schroders

## Economic and Strategy Viewpoint

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#### Global: US and emerging markets drive growth upgrade

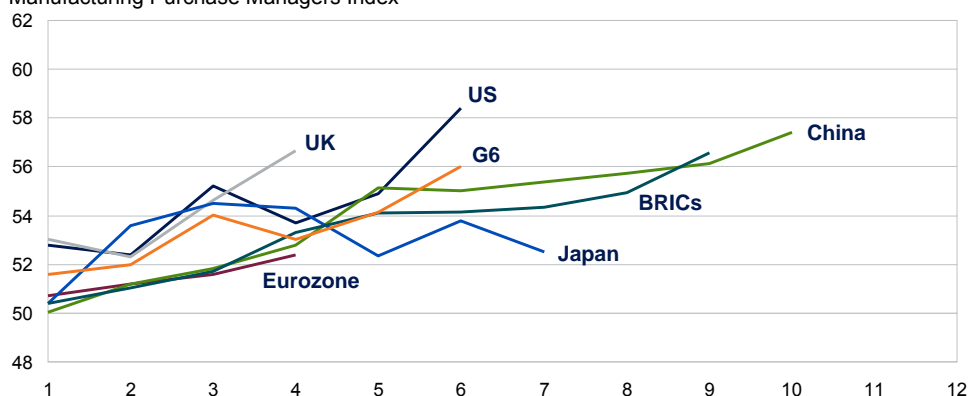
- We have increased our forecasts for global GDP growth in 2010 a result of upgrades to the US and emerging markets. We are now more confident of a sustainable recovery as an improving corporate sector is expected to increase capital expenditure and employment. However, ongoing de-leveraging pressures will limit the strength of the upturn.
- Whilst we see better prospects in the US and emerging economies our growth forecasts for the UK and Eurozone are little changed following a run of disappointing data and the likelihood of an earlier tightening of fiscal policy than previously expected. Policy tightening by the ECB and Bank of England has been delayed in the forecast as a result.
- We remain sanguine on inflation in the OECD economies as the output gap weighs on prices and drives core inflation lower. We do not subscribe to the view that governments will be willing or able to inflate away their rising debts. Inflation could however be a problem in the emerging economies where there are signs of over heating.
- Upside risks are for a stronger recovery in line with the past performance of economies emerging from a deep recession. On the downside, there is potential for the sovereign debt problems in the Eurozone to escalate, creating the risk of default and a more deflationary environment as the markets force governments to tighten fiscal policy more rapidly.

#### Eurozone: Green shoots wither in winter

- Fourth quarter Eurozone growth left little to be desired as domestic demand continues to be hampered by fears that unemployment will resume its upward trend. Many countries are still in recession while those that are doing better, have done so with substantial aid from the inventory cycle.
- Meanwhile, there has been a downward step change in sentiments towards Greek debt as the new government revealed the previous administration's attempts to hide the extent of the public finances crisis. Greece will now face greater EU scrutiny, though an EU bail-out is still likely to be needed.

#### The emerging markets are leading the recovery

Manufacturing Purchase Managers Index



No. of months index is above the 50 level

Source: Schroders, Markit PMI, February 2010

BRIC: Brazil, China, India & Russia; G6: US, UK, Germany, Italy, Japan and France. GDP weights based on nominal GDP in USD from IMF GDP weights based on nominal GDP in USD from IMF



# Global **Forecast update**

## US and emerging markets drive growth upgrade

### *The industrial sector is leading the recovery*

Despite the angst over the world economy, we are revising up our growth forecast for 2010 to 3.1% from 2.7%. This is driven by the US and emerging markets which have been enjoying a rapid rebound in industrial production. Our European growth forecast is little changed. The regional pattern reflects the behaviour of business surveys such as the purchasing managers indices (PMI's) which clearly show the emerging economies leading the cycle, followed by the US with Europe the laggard (see chart front page).

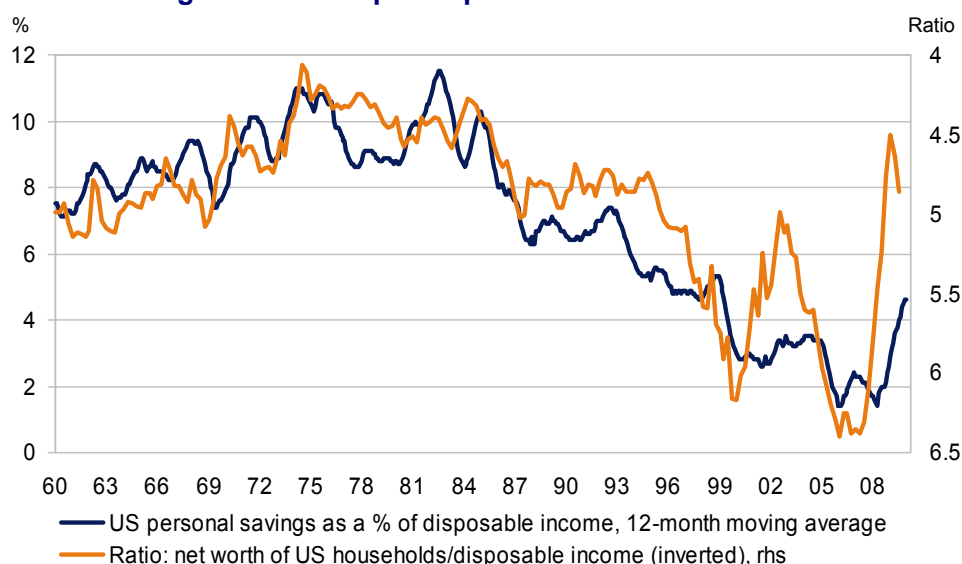
The revisions in the US reflect a better than expected performance at the end of 2009 (the economy recorded real GDP growth of 5.7% annualised in Q4) and a robust start to 2010. The inventory cycle has played a significant role in this outcome as firms rebuild their stocks of unsold goods providing an added boost to output. Growth is likely to slow as this effect fades in the spring, however we do not see a return to recession or a double dip. Final sales in the US (consumption and investment growth) are improving with retail sales and orders for durable goods beginning to rise again.

### *De-leveraging headwinds limit strength of upswing*

Underlying these developments is the turn in corporate profitability, which has resulted in a major improvement in cash flow. Companies have begun to invest again and, as can be seen in the monthly employment report, have stopped shedding labour. As unemployment falls, consumer confidence and income will be supported thus enabling spending to grow as we move through 2010.

In our view US growth is sustainable, but is unlikely to be strong. The need to rebuild balance sheets following the loss of wealth will limit household borrowing and spending. In other words savings rates will remain under upward pressure (see chart 1). Consequently our forecasts for US growth in 2010 and 2011 at 2.8% and 2.9% are a little below consensus (3.1% and 3% respectively).

**Chart 1: Savings rates face upward pressure in the US**



Source: Thomson Datastream, 24 February 2010

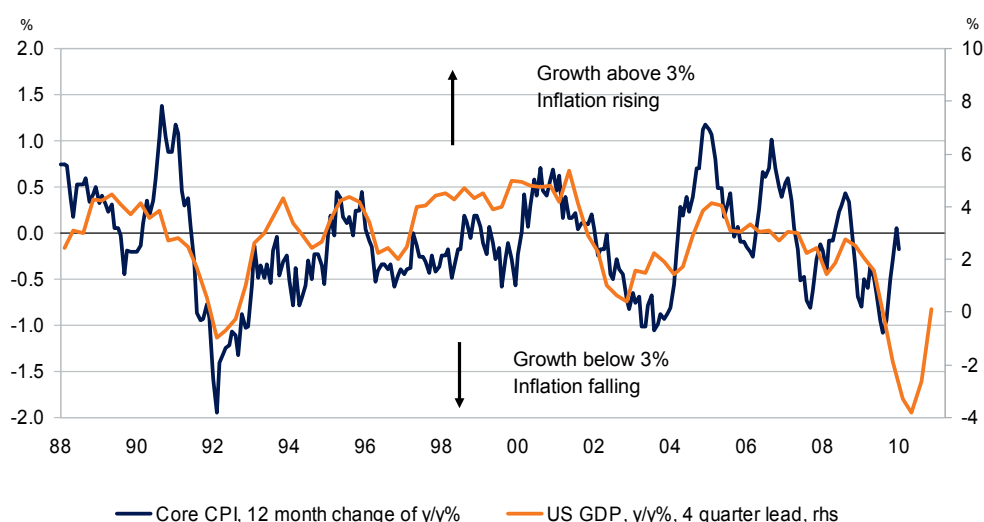
### **Emerging economies are enjoying a v-shape recovery**

The other source of stronger growth comes from the emerging markets. For the economies of Asia and Latin America the current cycle is not unlike those of the past where a sharp downturn is followed by a rapid upturn – the classic “V” shape. Although the emerging economies are affected by the slowdown in US demand, the absence of a domestic credit crunch removes a major headwind from growth. Fiscal policy is also playing a role and remains expansionary in the emerging markets, as in the US, in 2010. Strong export growth at the beginning of this year, particularly in Asia has led us to revise up our growth forecasts for 2010 to 6% from 5.1%.

### **Inflation to remain contained**

Although we have raised our forecasts for growth, inflation is expected to remain well behaved in the developed OECD economies. Although inflation has picked up recently, this is entirely due to the base effect from higher commodity prices. Core inflation (CPI ex. food and energy) is expected to remain on a declining path as the large output gap weighs on prices (chart 2).

**Chart 2: US GDP growth and core inflation**



Source: Thomson Datastream, Schroders, 24 February 2010

### **Inflation to surprise on the downside**

In the US this means core inflation (currently 1.6%) falls to 1% by the end of 2010 and to 0.7% by the end of 2011. For Japan it means a deepening in deflation. In the UK and Eurozone the pick up in inflation this year is expected to be higher than previously expected, largely the result of a weaker Euro and pound sterling than anticipated three months ago. Inflation is still expected to accelerate in the emerging economies as a consequence of overheating pressures.

Overall, our global inflation forecasts for 2010 and 2011 are little changed at 1.5% and 0.8% respectively. These forecasts are close to consensus in 2010, but below in 2011, particularly in the OECD economies.

### **Higher government debt, higher inflation?**

### **Increasing incentive to create inflation,**

Many commentators have taken the view that the high and rising level of government debt means that a period of higher inflation is inevitable – how else will governments escape their debts? Such an outcome is entirely possible. However, we take the view that this will not happen in the next five years or longer.

**but private sector de-leveraging is deflationary...**

Government debt has risen significantly and will increase further. However, it is difficult to find a significant relationship between inflation and high levels of public debt. What history does show is that periods of private sector de-leveraging are associated with weak growth, high unemployment and low inflation (see table 1 for the US experience). In the current environment this must be seen as a major offset to the perceived inflation risk from rising government borrowing.

**Table 1: US economic variables during periods of private sector de-leveraging (1916-2009)**

	No. of years	Real GDP growth	Inflation	Unemployment rate
De-leveraging	11	-0.9	0.4	11.7
Other periods	82	3.6	2.8	5.5

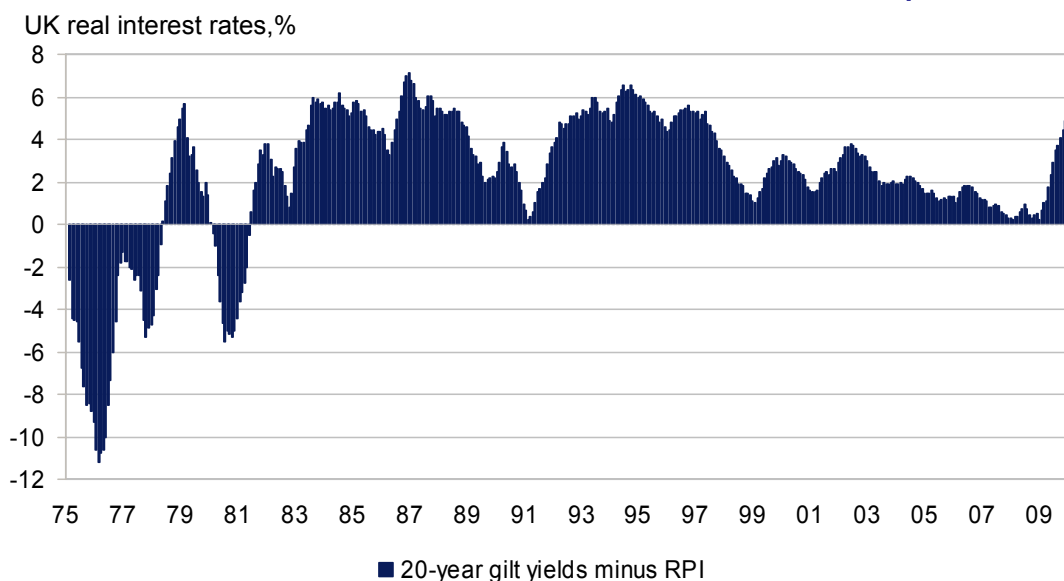
De-leveraging is defined as years when private debt to GDP declines by 10% or more.

Source: Reinhart and Rogoff (December 2009)

**...and those who create inflation pay a price**

Furthermore, even if it could be done by printing ever larger amounts of money, inflating away debt would have major consequences for governments in terms of the future cost of borrowing. After the inflation of the 1970s, bond investors demanded a very high premium in terms of real interest rates (see chart 3 for the UK case). The authorities took years to restore credibility. We believe unless governments stop the free flow of capital and force investors to hold their bonds it is difficult to create inflation without suffering a massive penalty in the form of higher yields.<sup>1</sup>

**Chart 3: After the inflation of the 1970's, bond investors demanded a premium**



Source: Thomson Datastream, 24 February 2010

<sup>1</sup> For more on the long term outlook for inflation see "Will the financial crisis be followed by a surge in inflation" Schroders Talking Point, February 2010

## Outlook for interest rates

### **UK & Eurozone rates to rise later than previously expected**

On the policy front we have made no change on the US with the first rise in Fed funds scheduled for September this year. The Fed continue to state that “economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period”. Nonetheless, the decision to raise the discount rate on February 18<sup>th</sup> indicates that the authorities are keen to start the exit strategy. We are likely to see further rises in the discount rate and increased interest payments on bank reserves before the Fed funds rate increases.

Given the relatively weaker macro backdrop in Europe we have pushed our forecasts for the first move in policy rates in the UK and Eurozone out to November this year and January 2011 respectively. Both also face greater fiscal headwinds over the forecast than the US.

**Table 2: Forecast comparison**

	Previous	New	Difference	Previous	New	Difference
<b>Real GDP</b>		<b>2010</b>			<b>2011</b>	
OECD	1.7	1.9	0.2	2.1	2.1	0.0
Emerging	5.1	6.0	0.9	5.7	5.7	0.0
World	2.7	3.1	0.4	3.2	3.2	0.0
<b>Inflation CPI</b>						
OECD	1.5	1.5	0.0	0.9	0.8	-0.1
Emerging	5.7	5.8	0.1	5.3	5.3	0.0
World	2.8	2.8	0.0	2.2	2.2	0.0
<b>Interest rates</b>		<b>End of 2010</b>			<b>End of 2011</b>	
US	1.00	1.00	0.0	2.50	2.5	0.0
UK	1.25	1.00	-0.3	2.50	2.0	-0.5
Eurozone	1.50	1.00	-0.5	2.00	1.8	-0.3
Japan	0.10	0.10	0.0	0.25	0.3	0.0

Previous: last Quarterly forecast December 2009

Source: Schroders February 2010

## Risks

There are two alternative scenarios to this baseline view.

### 1. V-shape recovery

The first would be a stronger recovery where the growth path is a V shape. In this scenario we would see a more powerful upswing as consumers begin to spend and companies invest. Growth in the emerging markets would accelerate further as trade revives.

### **Previous recoveries have been stronger than our baseline**

In many ways this would be closer to the typical recoveries experienced in the past where output behaves as if on an elastic band i.e. the greater the fall, the greater the bounce back. For example looking at major recessions in the US, in the first year of recovery from the trough, GDP rose by an average of 6.4% and in the second year the gain was 4.6%. In our baseline forecast we have 3% growth in each of these years, well below the norm (see table 3).

**Table 3: GDP rebounds after major recessions**

Start date	Peak to trough	Recovery Year 1	Recovery Year 2
Q2 1953	-2.6	6.3	3.1
Q3 1957	-3.7	7.5	5.1
Q4 1973	-3.2	6.2	3.2
Q3 1981	-2.7	5.6	6.9
<b>Average</b>	<b>-3.1</b>	<b>6.4</b>	<b>4.6</b>
Q4 2007	-3.7	3.0f	3.0f

Source: Datastream, Schroders, NBER

Such strong rebounds are often generated as firms have over-reacted in the downturn and now need to rapidly adjust to a better than expected level of sales. There is an element of this in the current cycle, but the missing piece compared with the past is a powerful impact from monetary policy which remains constrained by the unwinding of debt. Nonetheless, a sharper rebound remains a risk.

Clearly such an outcome would result in a far more rapid exit strategy by central banks with the result that interest rates would be expected to rise to 5% in the US and UK and 4% in the Eurozone by the end of 2011. The emerging economies would experience greater overheating pressures.

## 2. Sovereign default in the Eurozone

**Default is not the central case, but represents a significant risk**

The second scenario is one where the current situation in the Eurozone deteriorates resulting in a default by Greece. In a recent survey of investors the majority expected a last minute EU bailout. However, a sizeable minority expected a restructuring of interest payments with Greece remaining in the Euro. Note that UK based investors thought this just as likely as the last minute bailout and also attached a significant probability to a more disorderly outcome (table 4).

**Table 4: What do you see as the most likely outcome of the current situation in Greece?**

% saying	Global	Europe	UK	US	Japan
<b>Resolves the situation on its own</b>	11	14	0	10	0
<b>Last minute EU bailout</b>	58	61	33	62	65
<b>Orderly default/restructure and staying in Eurozone</b>	25	22	33	19	29
<b>Disorderly default and exit from Eurozone</b>	2	2	22	0	0
<b>Son't know/ Not available</b>	4	2	11	10	6

Source: Bank of America/Merrill Lynch Global Fund Manager Survey, February 2010

Our base case assumes a last minute bail out which contains the crisis and prevents it spreading to other members of the Eurozone. However, we would attach a significant probability to an orderly default. For two reasons.

**Bailout is not guaranteed,**

First, despite the rhetoric of politicians, there is considerable antipathy towards Greece following the admission that the authorities have consistently manipulated official statistics to gain admission to the Euro and avoid earlier action on the budget deficit. Politicians also know that any bail out will have to be justified to a European public who ask why they should be subsidising early retirement and generous pensions for Greeks.

**and Greece may  
not stay the  
course**

Second, the fiscal plans which have been accepted by the EU finance ministers are very tough and potentially condemn Greece to 3 years of recession. Policy is set to tighten by 4% of GDP this year and 3% in the next two years. This would be difficult to implement even if the world economy were growing rapidly, which is unlikely. Consequently, a default will remain a risk even if Greece survives the next round of refunding in April and May when €23bn comes due (see chart 10 below).

If Greece defaults, the result is likely to be pressure on other countries in the Euro area who will then have to speed up fiscal tightening to placate the markets. The pressure could easily spread to the UK which expected to run a budget deficit of 12% of GDP this fiscal year. The Euro and possibly sterling are likely to fall sharply against the US dollar. The US could also suffer if credible fiscal plans were not in place to head off concerns about the level of debt.

Overall the impact would be deflationary for the world economy resulting in lower growth and inflation. Central banks would respond by keeping monetary policy looser for longer – i.e. would delay their exit strategy to enable governments to sort out their fiscal positions.

## Eurozone **Green shoots wither in winter**

Despite promising survey evidence towards the end of 2009, official economic data has disappointed so far this year. Eurozone growth was markedly weaker in the final quarter of 2009, and there are signs that job shedding may resume this year as firms look to improve productivity in the absence of a strong recovery.

Meanwhile, markets have been frantically reacting to increased fear of Greece defaulting on its sovereign debt. The potential scenario (see global section) would be devastating for Europe and so it is no surprise to see German and French politicians rushing out statements to suggest some type of bail-out is being considered by Eurozone members.

### **GDP growth slows in Q4 2009...**

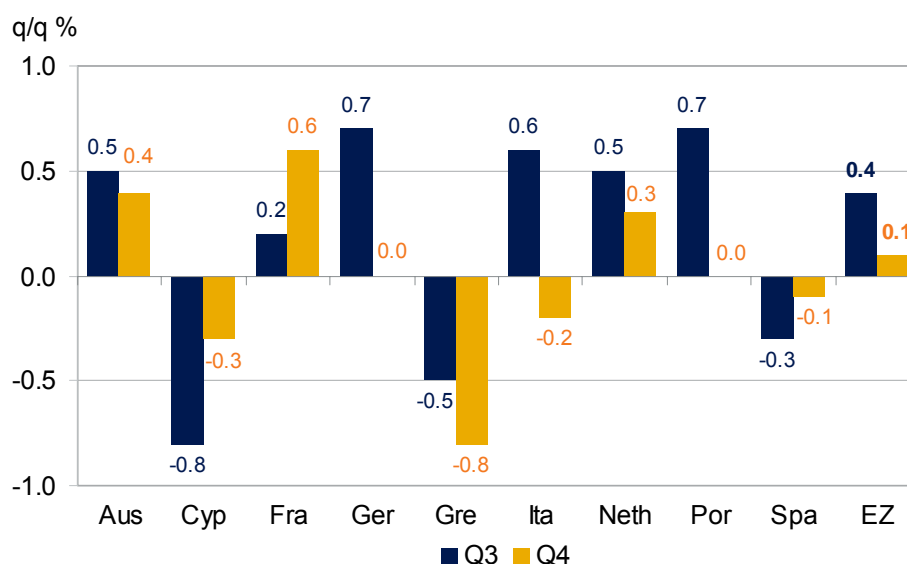
Whether Greece defaults, is bailed-out, or struggles along without any further crisis, European leaders will now be much more alert to the dangers of not fulfilling promises to reign in public deficits. As a result, the main change to our Eurozone growth forecast is driven by an increased likelihood of greater and faster fiscal tightening in 2011.

### **Sporadic and uneven growth**

Eurostat estimate Eurozone growth as a whole to have slowed from 0.4% in the third quarter of 2009 to just 0.1% in fourth quarter. Though the slowdown was larger than expected (Bloomberg Consensus of 0.3%, Schrodgers 0.2%), weaker production output and retail sales data suggested risks were to the downside

The biggest contributor to the slowdown in Eurozone growth was Germany, which saw GDP growth stall in the final quarter of 2009 (chart 4). Elsewhere, Italy slipped back into negative growth, while Spain, Cyprus and Greece all failed to exit recession. France was the one saving grace in the fourth quarter with growth accelerating from 0.2% to 0.6%.

### **Chart 4: Latest GDP growth**

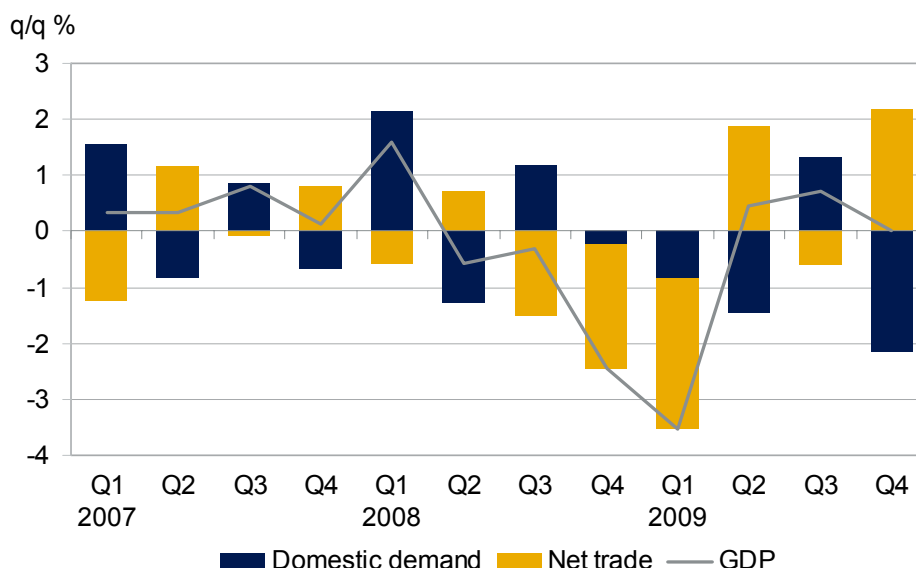


Source: DataStream, Eurostat, 24 February 2010

**...though we had expected a slowdown in German...**

We had been concerned that German growth in the third quarter of 2009 was dominated by the contribution from a slowdown in de-stocking. Excluding inventories, growth in the third quarter would have been -0.7% rather than +0.7%. Moreover, the latest GDP estimate reveals very weak domestic conditions. Chart 5 shows quarterly GDP growth for Germany broken-down into contributions from net trade<sup>2</sup> and domestic demand<sup>3</sup>. The latest estimate shows the largest fall in domestic demand since the start of this crisis, with household consumption, investment and government spending all making negative contributions.

**Chart 5: Germany GDP breakdown**



Source: DataStream, Eurostat, 26 February 2010

**...as households remain cautious over job prospects.**

The weakness in German domestic demand is being blamed on two key factors: first, the coldest winter in 14 years may have deterred shoppers and hindered industrial production. The second and probably more important factor is the expiry of the car scrappage scheme. New car registrations in the three months to July 2009 were up 36.8% against the same period a year earlier. However, in the three months to January 2010, registrations were only up 4.2% on the previous year, and were down 25.8% on the previous three months. It appears that much of the boost provided to car manufacturers has been at the expense of future purchases.

We highlighted this as a risk last year<sup>4</sup> and as such, expected most of the deterioration in activity being recorded today. German households continue to be concerned about job prospects, fully aware that the smaller-than-expected rise in unemployment so far has been greatly influenced by the government's short-time working subsidies (Kurzarbeit). Indeed the falls in the level of unemployment at the end of 2009 have not continued into the new year. German unemployment rose by 13,000 people in January and February, pushing the unemployment rate back up to 8.2%.

<sup>2</sup> Net trade = exports - imports

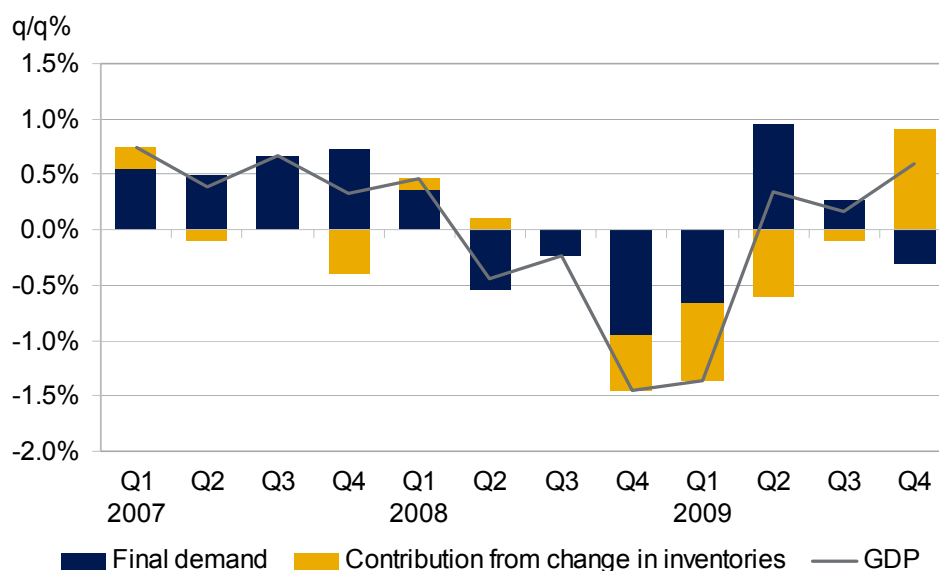
<sup>3</sup> Domestic demand = household consumption + investment + government spending + change in inventories.

<sup>4</sup> See Economics and Strategy Viewpoint August 2009, page 10 and chart 14.

### Will France experience a similar slowdown?

Given what is happening in Germany, can we expect a similar slowdown in France? Chart 6 shows French real GDP growth, as well as the contribution from the change in inventories, and final demand<sup>5</sup>. Like Germany in the third quarter, France has received a considerable lift from a slowdown in de-stocking in the fourth quarter. And like Germany, the contribution from the stock cycle could fall in the coming quarters.

**Chart 6: France GDP breakdown**



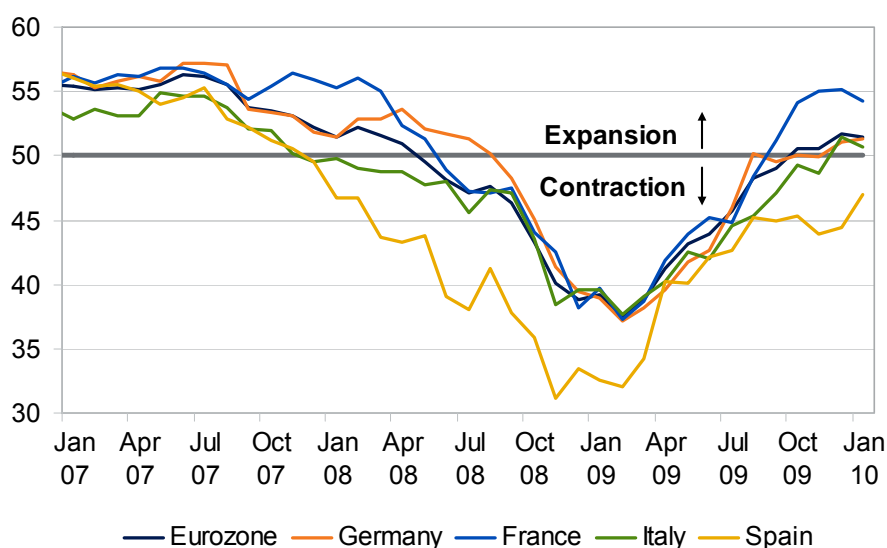
Source: DataStream, INSEE, 26 February 2010

Supporting this view are developments in France's car scrappage scheme. New car registrations in France are up 36.4% in the three months to January compared with a year earlier, with the peak lagging behind the German data. However unlike Germany, France is slowly reducing the incentives offered to consumers<sup>6</sup>, which should mean a less sudden decline in demand for new cars.

In addition, France's PMI Macro-composite has been much stronger than the Eurozone average and those of Germany, Italy and Spain (chart 7). This is also true when comparing consumer confidence surveys. Therefore, while we do expect new car registrations and general activity to moderate in France in the first half of 2010, better demand conditions should mean a less drastic slowdown relative to that in Germany.

<sup>5</sup> Final demand = household consumption + investment + government spending + net trade.

<sup>6</sup> The French Car scrappage scheme offered a €1,000 subsidy for the average car, and more for older, more polluting cars. The €1,000 subsidy was reduced to €700 on the 1<sup>st</sup> of January, and will be reduced to €500 in July.

**Chart 7: Purchasing managers indices (PMIs) – Macro composite\***

Source: Markit, 26 February 2010.

\*Macro composite produced by Markit by creating a weighted average of Manufacturing and Services PMIs, using GDP sectoral weights.

***Greece reveal true past borrowing and raise deficit cutting targets for 2010...***

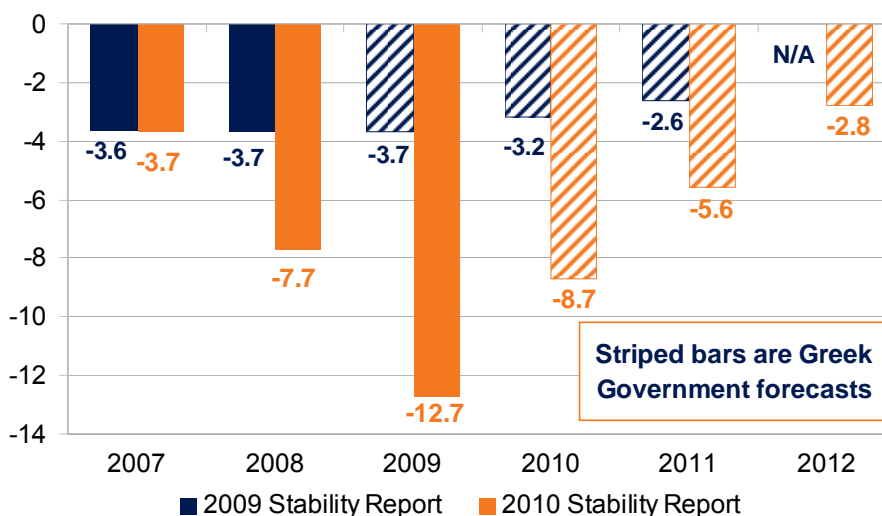
**Bond vigilantes test EU solidarité**

Heading into the new year, European government bond markets were recovering from the Dubai World fiasco, safe in the knowledge that European governments would be fiscally more responsible, especially with institutional surveillance in the form of the Stability & Growth Pact, and the Excessive Deficit Procedure (EDP) – or so they thought. News that Greece had covered up past borrowing raised the alarm and has shifted the cross-hairs of bond vigilantes back on Athens.

Fearful of the threat of higher borrowing costs, Greece came clean on past borrowing and announced more ambitious fiscal tightening in their updated (January 2010) Stability Report. Shockingly, the previous government reported Greece's 2008 deficit to have been 3.7% of GDP in their 2009 Stability Report. However, this year's report reveals that the 2008 deficit was actually four percentage points of GDP higher (chart 8). The new report states that Greece now aims to reduce its general government deficit from 12.7% of GDP in 2009 to 8.7% of GDP in 2010, and to bring the deficit down below the Maastricht Treaty 3% target by 2012.

**Chart 8: Greek government deficit statistics and forecast**

General government net debt (% of GDP)



Source: Greece Ministry of Finance, 24 February 2010

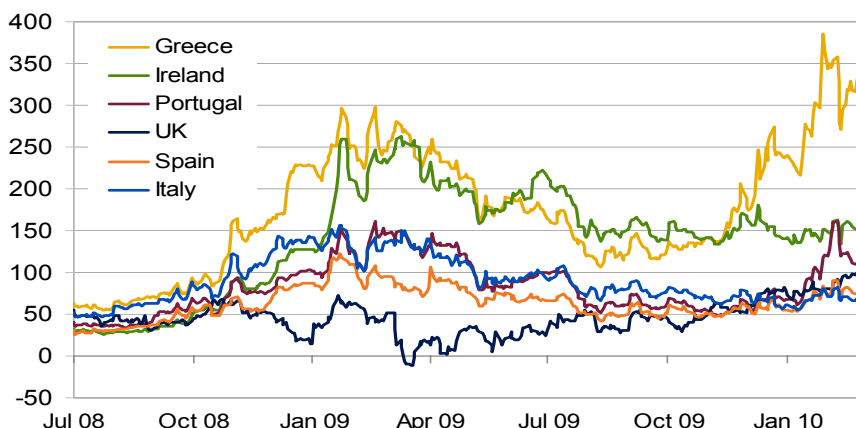
**...EU back Greek plans but market is looking for a bail-out...**

As part of the EU's annual multilateral-surveillance, the European Commission publically backed Greece's deficit reduction targets, but warned that Greece's GDP growth forecast may be too optimistic. It also warned that the Ministry of Finance's reliance on improving systems to prevent tax evasion is unlikely to yield the 1% of GDP in deficit reduction it expects. As a result of failing to meet past targets and the seriousness of the state Greece's public finances, the European Council for Economic and Finance ministers (EcoFin), decided to move Greece to the final stage of the Excessive Deficit Procedure. This means that Greece will be forced to submit a timetable for the implementation of fiscal measures in March, and report to the council every quarter from May. Failure to satisfy EcoFin would results in fines.

As the above complex and arduous procedure took place in Brussels, the rest of the world was fixated on Monsieur Trichet at the February ECB press conference. Trichet confirmed that the central bank is not allowed to provide monetary assistance to Greece (or any other sovereign) in accordance with the Maastricht Treaty. He also called for greater effort to be made by all Eurozone members in planning and implementing fiscal consolidation at the earliest opportunity. Markets were disappointed by the lack of support and the veiled finger pointing at Spain and Portugal, leading to a sell-off in sovereign bonds with particularly poor pubic finances (chart 9)

**Chart 9: Government bonds yields**

10yr Govt. bond yield spreads over Bunds, Bps



Source: DataStream, 25 February 2010

**...which may take time to agree.**

As bond yields rocketed, rumours began to emerge that Germany & France were spearheading a campaign to help Greece. Anonymous quotes flooded newswires and bond yields began to settle once more. Speculation was rife that final touches were being made to a Eurozone bail-out plan and that it would be unveiled at the new EU President's (Herman Van Rompuy) extraordinary meeting of European Leaders. In fact, the meeting was called to discuss broader structural economic reform. Greece was discussed in several bi-lateral meetings and more formally over a working lunch, but France and Germany failed to agree on a solution that satisfied all parties. Rumours suggest that France was happy to offer aid though Germany wanted more stringent conditions including specific tax rises for Greece (raising VAT by 1% amongst other measures). With the thought of Germany (or the EU) dictating fiscal policy to other member states, Greece held their public line that they are not asking for a bail-out and are determined to reduce their deficit as planned.

EU leaders publically re-iterated their support for Greece, but focused comments on the support provided through the Excessive Deficit Procedure rather than a bail-out. Markets had gotten ahead of themselves and had underestimated the resistance in Europe to readily provide support for an irresponsible nation. Since then, Greek government debt yields resumed their upward trend.

**Meanwhile, Greek public opinion has swung behind its government's plans and the EU.**

While the use of multilateral surveillance did little to appease markets, European rhetoric has proven useful in the past in helping government convince their public for the need to implement reforms. Evidence so far suggests it is doing the same in Greece. A poll published in a daily Greek newspaper showed that 57.6% felt the government are headed in the right direction on fiscal policy and 74.2% felt that if anything, the government were unjustified in delaying austerity measures.<sup>7</sup> The quarterly European Commission poll showed trust for the European Union has risen from 55% to 60% between the third and fourth quarter of 2009, while distrust for the Greek government fell from 75% to 54%. Interestingly, approval of EU membership rose from 45% to 61%.

<sup>7</sup> Poll conducted by MARC and published in Ethnos daily newspaper on 21 February 2010.

Where you will find discontent in Greece is amongst the public sector where budgets are being frozen or cut. On the 24<sup>th</sup> of February, Adedy, the general public sector union held a second 24-hour national strike. This time however, they were joined by GSEE members – a private sector union federation. Heavy disruption of public services ensued with Athens airport closed amongst many public service.

**Step change in sentiments**

*It is hard to argue against the downward step change in sentiments towards Greece's ability to repay its debt.*

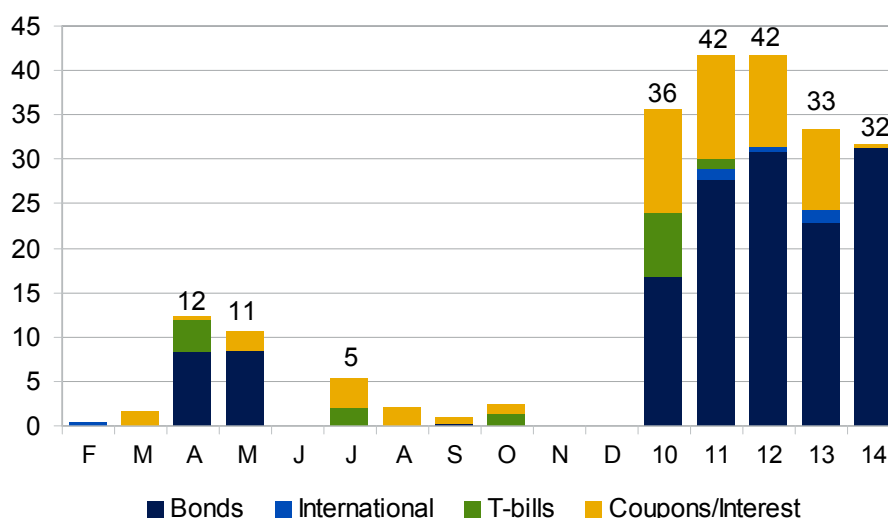
Since the start of the year, there has been a downward step change in sentiments towards Greek sovereign debt. Greece presented itself as an obvious target for bond vigilantes last year though the thought of default was still seen as a distant tail risk. The situation now is more serious with markets treating Greek debt as a bomb waiting to detonate. Looking closely at Greece's financing needs, it is becoming increasingly difficult to argue against such sentiment.

In his latest attempt (of many) to reassure investors, Greece's Prime Minister George Papandreou naively revealed in a BBC interview that Greece had enough funding to last until mid-March. Chart 10 shows Greece's monthly debt repayment obligations over the rest of 2010, and annual repayments due based on its current debt profile. From the chart, April and May stand out as the pressure points in Greece's debt calendar; having to repay €23 billion, or two-thirds of their debt obligations for the year.

*Greece must find €23bn to repay debt and interest due in April and May...*

**Chart 10: Greece debt and interest schedule**

Debt roll-over schedule, billions, €

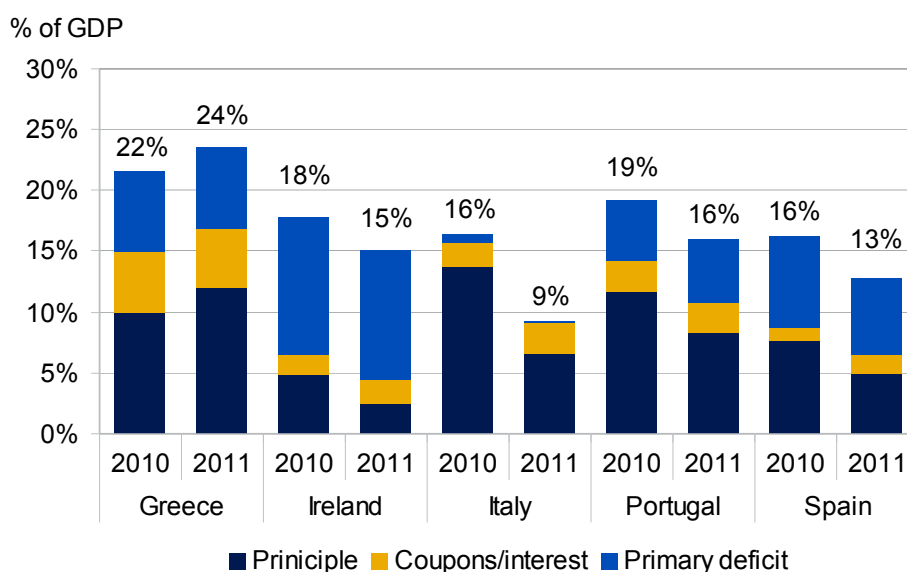


Source: Bloomberg, 23 February 2010.

To put the above in to context, we have added the European Commission's forecast government borrowing excluding interest payments (primary deficit), and presented it as a share of GDP in chart 11. When compared to Ireland, Italy, Portugal and Spain, it becomes very clear why markets are concerned. Greece is expected to issue debt worth approximately 22% of GDP in 2010, and a further 24% of GDP in 2011 where as, all of the other countries on the chart are expected to issue less debt than Greece as a percentage of GDP, but also less debt in 2011 than in 2010. From the chart, Italy also stands out as a potential outperformer thanks to its relatively small government deficit.

**...with total issuance estimated to reach a huge 22% of GDP for 2010.**

**Chart 11: Potential debt issuance 2010/2011**



Source: DataStream, ONS, Schroders, 23 February 2010

**A bail-out for Greece means less incentive for member states to manage their public finances responsibly...**

### **To bail-out, or not to bail-out: Catch 22**

The decision of whether or not to help Greece, and potentially Spain and Portugal later, is very difficult and potentially politically explosive. A monetary bail-out from Germany would be extremely difficult to sell to the German people, who are already facing the prospects of later retirement and a weak economic recovery. In addition, whether the bail-out takes the form of actual funding or some kind of guarantee, the action would increase moral hazard substantially. In other words, Eurozone member states would have less incentive to reduce their unsustainable levels of borrowing. Moreover, there will be a partial transfer of risk from Greece to Germany and France. This will not sit well with German and French debt investors who in turn would demand a higher risk premium to invest.

The alternative would be to let Greece default. All types of questions then arise but crucially, would Greece be allowed to exit the monetary union. In our view, this disorderly default scenario is very unlikely, partly because of the practicalities of changing Greece's monetary system, but also because of the extreme instability an exit would cause to the Greek economy.

**...though a default could trigger the next banking global crisis.**

An orderly default is more likely whereby Greece reschedules interest payments and suffers the consequences of market reactions. According to the Bank of International Settlements, German and French banks have significant exposure to Greek government debt, and so even an orderly default by Greece could spark a contagion that causes a second initially European, but eventually, global banking crisis.

Therefore, our central view remains that should Greece experience financial distress, support will be made available to them. The form of the support and the speed of which it is provided presents risks, and so we expect greater volatility in the run up to Greek auctions in the coming months.

## Conclusions and forecast update

Fourth quarter Eurozone growth left little to be desired as domestic demand continues to be hampered by fears that unemployment will resume its upward trend. Due to the small downside surprise, we have slightly downgraded our forecast for Eurozone real GDP growth for 2010 as a whole (table 5).

**Forecast changes reflect Greece default risks and consequences of tighter fiscal policy in 2011.**

**Table 5: Eurozone & UK forecast update**

y/y%	Real GDP		CPI Inflation		Interest rates	
	2010	2011	2010	2011	End-2010	End-2011
<b>Eurozone</b>	1.0 (1.2)	1.4 (1.6)	1.7 (0.8)	0.7 (0.9)	1.00 (1.50)	1.75 (2.00)
<b>UK</b>	1.1	2.5	2.5 (2.2)	2.2 (2.4)	1.00 (1.25)	2.00 (2.50)

Source: Schroders, 26 February 2010. Previous forecast in brackets

We have also downgraded our 2011 growth forecast as we are factoring in greater and earlier fiscal tightening than previously, which we expect to cause a slowdown in quarterly growth in the second half of 2011.

Due to the need to support fiscal consolidation, we have pushed back our first increase in the ECB policy rate to January 2011, and have lowered the profile over all.

Our headline inflation forecast for the Eurozone has been revised up significantly with the main cause being the recent depreciation in the Euro, and our forecast for the currency as described in the earlier section of this note. However, our core inflation profile remains extremely weak – annual core inflation for 2010 as a whole of 0.5% and 0% for 2011.

For the UK, our below consensus growth forecast remains on track. The headline inflation forecast has also been revised up, again partly due to weakness in Sterling, but also due to slightly higher than anticipated outturns in data for January. We expect headline inflation to fall from its current level (3.5%) over most of 2010, but begin to turn and rise again in 2011.

Core inflation should follow a similar profile, but we expect it to be lower than headline inflation (2.1% for 2010 and 2% for 2011). As we are in line with the Bank of England's inflation profile for most of 2010, we see little danger in rates being raised in the near future and have pushed back the first rate rise in our forecast to November 2010.

## Forecast Summary

### I. Forecast summary

Real GDP								
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus	2011	Consensus
US	27.3	0.4	-2.5	-2.4	2.8	3.1	2.9	3.0
UK	5.1	0.5	-5.0	-4.8	1.1	1.4	2.5	2.2
Eurozone	25.8	0.6	-4.0	-3.9	1.0	1.3	1.4	1.5
Japan	9.3	-1.2	-5.1	-5.3	2.0	1.5	1.6	1.5
Australia	1.9	2.5	0.9	1.0	2.7	3.0	3.0	3.3
OECD	69.5	0.3	-3.5	-3.4	1.9	2.1	2.1	2.2
China	8.2	9.0	8.6	8.7	10.0	9.8	9.0	9.1
Emerging*	30.5	5.4	1.1	0.6	6.0	5.6	5.7	5.7
World	100.0	1.9	-2.1	-2.2	3.1	3.2	3.2	3.3

Inflation CPI								
y/y%	Wt (%)	2008	2009	Consensus	2010	Consensus	2011	Consensus
US	27.3	3.8	-0.3	-0.3	1.9	2.3	1.0	2.0
UK	5.1	3.6	2.2	2.2	2.5	2.6	2.2	1.7
Eurozone	25.8	3.3	0.3	0.3	1.7	1.2	0.7	1.5
Japan	9.3	1.7	-1.1	-1.4	-1.3	-1.0	-0.7	-0.3
Australia	1.9	4.5	1.8	1.8	2.4	2.5	2.5	2.8
OECD	69.5	3.3	0.0	0.0	1.5	1.5	0.8	1.5
China	8.2	5.9	-0.7	-0.7	4.5	3.2	4.0	3.3
Emerging*	30.5	8.0	4.3	4.0	5.8	5.4	5.3	5.0
World	100.0	4.8	1.4	1.2	2.8	2.7	2.2	2.6

\* Emerging markets: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Slovakia, Romania, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

Interest rates								
%	Wt (%)	Dec-08	Dec-09	Market	Dec-10	Market	Dec-11	Market
US	27.3	1.00	0.25	-	1.00	0.95	2.50	2.46
UK	5.1	2.00	0.50	-	1.00	1.24	2.00	2.67
Eurozone	25.8	2.50	1.00	-	1.00	1.28	1.75	2.16
Japan	9.3	0.10	0.10	-	0.10	0.39	0.25	0.50
OECD	67.5	1.52	0.53	-	0.88	1.02	1.87	2.09

Market data as at

22/02/2010

Key variables								
FX	Current	Dec-08	Dec-09	y/y%	Dec-10	y/y%	Dec-11	y/y%
USD/ GBP	1.55	1.49	1.62	9.1	1.50	-7.5	1.55	3.3
USD/ EUR	1.36	1.35	1.46	7.7	1.30	-10.8	1.35	3.8
JPY/ USD	91.1	91.1	90.0	-1.2	95.0	5.5	97.5	2.6
GBP/ EUR	0.88	0.91	0.90	-1.3	0.87	-3.6	0.87	0.5
Brent crude	77.4	40.5	74.9	84.8	79.1	5.6	80.3	1.6
US output gap %GDP	-8.0	-4.2	-8.0		-6.3		-3.9	
Unemploy. %	10.0	6.9	10.0		9.3		8.1	

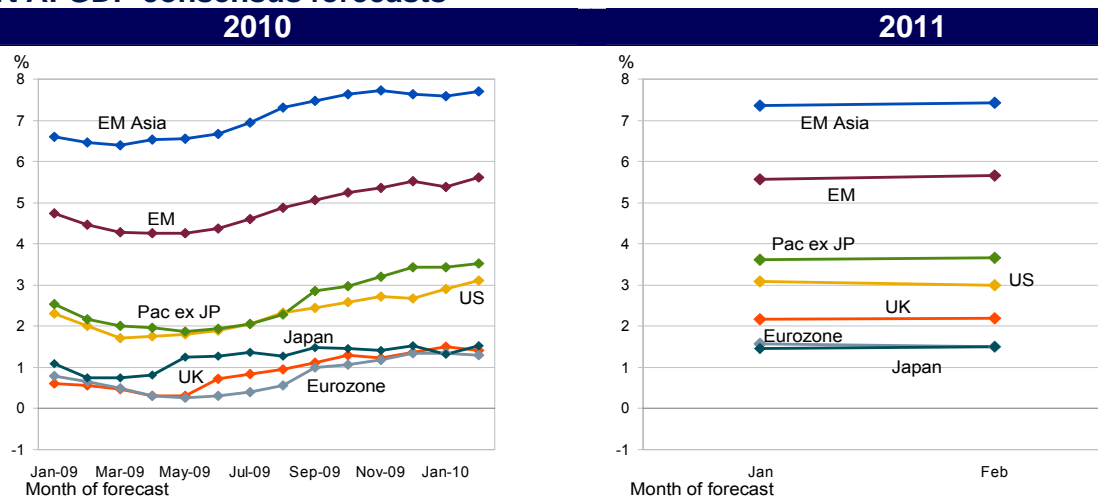
Source: Schroders, Datastream, IMF, Consensus Economics (Feb. 10)

- Our forecast for global growth have been raised by 0.4% since the last CMF with the world economy now expected to grow by 3.1% this year. For 2011 we expect global growth of 3.2%, unchanged from last December. The upgrade has been driven by the US and emerging markets, with little change in the European forecasts.
- After the recession of 2008 and 2009H1, the recovery has been driven by the industrial sector and stronger government spending. The main impact was in 2009Q4 and should last until 2010Q1. In mid-2010 we would look for growth to slow as the inventory cycle fades while final sales are constrained by ongoing de-leveraging in the household sector, tax increases and higher commodity prices. Thereafter, growth is expected to pick-up again as the corporate sector begins to recruit and employment rises following the improvement in profitability.
- After falling sharply in 2009, headline inflation is forecast to rise in 2010 following the recovery in commodity prices. However, outside commodities, deflationary pressures persist and the US is expected to experience a decline in core inflation (CPI ex.food and energy) through 2010 and 2011. In the absence of further gains in commodity prices, the slack created by the downturn keeps downward pressure on inflation such that the headline rate falls back in 2011. The pattern in the EM economies is different as there is less spare capacity and in economies like China, excess money growth is likely to push inflation higher in 2010 and 2011.
- Interest rates in the US are not expected to rise until September 2010 as the central banks pursue a cautious exit strategy from the ultra-loose period of monetary policy. By historical standards, rates stay very low through out the forecast period. Rates are forecast to rise in the UK in November and January next year in the Eurozone.

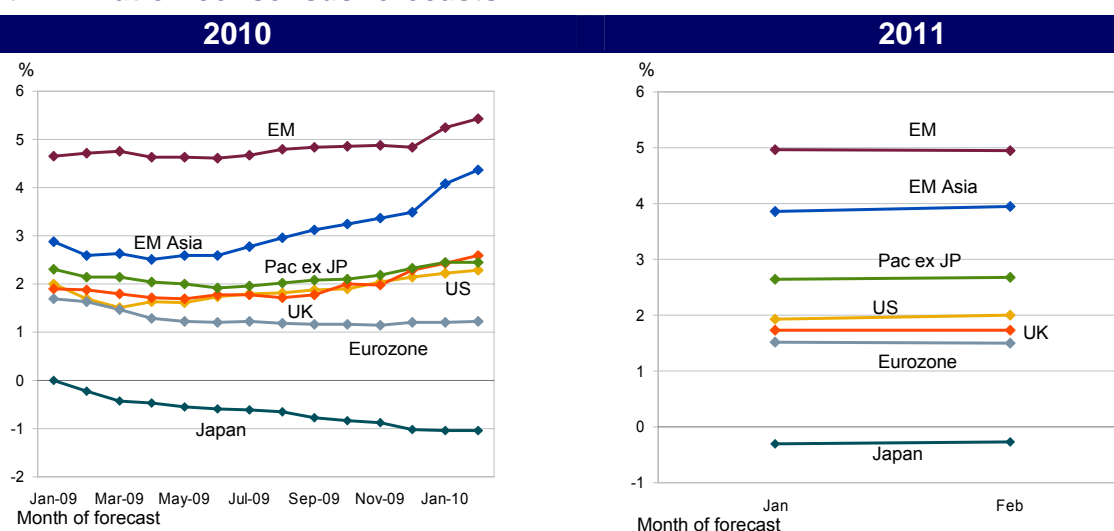
## II. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

### Chart A: GDP consensus forecasts



### Chart B: Inflation consensus forecasts



Source: Consensus Economics (February 2010), Schroders  
 Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore  
 Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand  
 Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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